

BUYING DISCOUNTED PROPERTY?

"EXAMINE THE AFTER-TAX BENEFITS OF A 1031 EXCHANGE"



Compliments of

Given the expected changes in capital gains rates, investors should consider potential taxes on a future sale before making a decision to buy or sell. For real estate investments, there are three tax scenarios that could apply to a sale: (i) short term gains at ordinary income tax rates (35% through 2010 and 39.6% thereafter), (ii) long term capital gains tax rates (15% through 2010 and 20% thereafter), or (iii) deferral of state and federal taxes through a §1031 tax deferred exchange. The foregoing is a bit of a simplification, but provides a simple analytic framework to illustrate the tax impact of various real estate sale scenarios. To understand these tax classifications and the corresponding tax rate structures more thoroughly, review [Ordinary Income vs. Capital Gain Taxation](#).

Let's look at a real estate buyer who purchases two distressed properties at a significant discount (either a short sale seller or a lender who has already foreclosed on property that secured a non-performing loan). For this example, assume the properties are purchased for \$140,000 each, a 30% discount from the fair market value of \$200,000 each. Also assume the taxpayer is in the top federal tax bracket and pays state taxes at a rate of 10%. If the taxpayer sells both properties immediately after they are acquired, the taxpayer will realize a before-tax return of \$92,000 (assuming no repairs and approximately 7% for commissions and closing costs; $2 \times \$60,000 = \$120,000$ minus \$28,000 closing costs). So, let's analyze the after-tax dollars that will remain after the sale and consider the potential impact of a 1031 exchange to evaluate the best investment strategy. As demonstrated below, real estate investors who exchange have a much better after-tax return on investment, resulting in considerably greater purchasing power and more wealth accumulation.

ANALYZING THE AFTER-TAX IMPACT

2010

Ordinary Income Tax Rate: 45% (35% Federal plus 10% state)

Taxes Owed: \$41,400 in combined state and Federal ordinary income taxes

Equity Remaining to Reinvest: \$50,600

2011

Ordinary Income Tax Rate: 49.6% (39.6% Federal plus 10% state)

Taxes Owed: \$45,632 in combined state and Federal ordinary income taxes

Equity Remaining to Reinvest: \$46,368

A MORE TAX EFFICIENT SOLUTION: 1031 EXCHANGES

Tax Rate: 0%

Taxes Owed: \$0

Equity Remaining to Reinvest: \$92,000

Investors purchasing discounted properties may want to consider purchasing some of these properties in a separate legal entity, such as a limited liability company, that will hold property for investment. By segregating real estate assets that are held for investment from other assets that may be flipped for an immediate profit, an active real estate investor can preserve the opportunity to complete tax deferred exchanges on the property held longer term. By doing so, the investor can get the best of both worlds by generating immediate cash flow selling the property shortly after purchasing, and building equity long-term by holding some properties acquired for investment purposes. To explore this strategy further, contact Asset Preservation and review the article [How Long to Hold](#).



ASSET PRESERVATION
INCORPORATED

A National IRC §1031 "Qualified Intermediary"

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

apiexchange.com

info@apiexchange.com

Template # 137

Asset Preservation, Inc. does not give tax or legal advice. The information contained herein should not be relied upon as a substitute for tax or legal advice obtained from a competent tax and/or legal advisor.